preme Court at Washington as a final court of appeal from all tribunals, state and federal.

But although the Civil War has decided, more effectively than any judicial opinion, that we are a nation, and the amendments growing out of that great epoch have provided that citizenship in the nation shall not depend on race or color, and that there shall be no discrimination between citizens by a State, it has not yet been decided or provided that the independence as to local matters, which forms the strongest bulwark against that disintegration so often predicted, has ceased, and that the State in the administration of its laws is to be subjected to the surveillance of the national courts. And it is to be deplored that the Supreme Court of the United States, upon which chiefly rests the responsibility for preserving the proper relation of dependence and independence between things national and things local, should have adopted a course which may tend to countenance such an idea.

William H. Dunbar.

CAMBRIDGE, MASS.

A CREDITOR'S RIGHT TO HIS SURETY'S SECURITIES.

THE question for discussion is whether a debtor can pledge his property so as to indemnify his surety, without giving the creditor a preferred claim on the indemnity fund. In such a case it is not contemplated that the surety shall pay the debt out of the security in the first instance, but if through default of his principal he should be obliged to pay out of his own property, it is intended that he shall have recourse to the fund for reimbursement. One must distinguish carefully between three classes of cases: first, those in which the security is given primarily for the better protection of the debt; second, those in which the surety has the power, though not the duty, to apply the security in discharge of the debt; third, those in which the security is given merely for the purpose of indemnity. In the first class there can be no question that the creditor has the rights of any *cestui que*

trust; in the second, the rights of the creditor must be worked out, if at all, by a proceeding in the nature of an equitable trustee-process. These two classes we propose to exclude altogether from this discussion; our attention will be turned solely to those cases in which the security is given purely for indemnity.

The result will frequently be the same whether the security be applied in discharge of the debt, or whether it be retained for reimbursement; this is true where the surety is solvent and where the indemnity fund is equal in amount to the debt, but it will be readily seen that in case of insolvency or bankruptcy it makes a great difference whether the creditor be allowed to reach the security directly or whether he be obliged to rank with the general creditors.

The question has been frequently before the courts both in this country and in Great Britain, and various results have been reached which cannot be reconciled. It is proposed to consider the cases under the following four heads, which, it is believed, will be found to comprise most of the decisions: first, where the security for personal indemnity is held to constitute a trust fund for the payment of the debt; second, where the equity of the creditor does not arise until the insolvency of the surety; third, the English cases, following the rule of *Ex parte* Waring, that in the event of double bankruptcy the creditor may reach the security; fourth, the Scotch decisions, according to which the holder of the obligation has no claim to the security, though indirectly he may, in common with the general creditors, derive a benefit from its existence.

The first case on record is that of Maure *v.* Harrison,[1] in which it is stated that "a bond creditor shall in this court have the benefit of all the counter-bonds or collateral securities given by the principal to the surety; as, if A owes B money, and he and C are bound for it, and A gives C a mortgage or bond to indemnify him, B shall have the benefit of it to recover his debt." This case has remained a solitary decision in England, and is at variance with *Ex parte* Waring.[2] The doctrine as it stands, without qualification, is that all securities given by a principal to his surety are held in trust; the case was so interpreted in New York,[3] at an early period, and may be said to lie at the basis of most of the

[1] 1 Eq. C. Abr. p. 93. [2] 19 Ves. 345.
[3] Moses *v.* Murgatroyd, 1 Johns. Ch. 119.

American law on this point. The reasons given by the courts for deciding that this transaction creates a trust, even where the funds are given for the surety's indemnity alone, are, to say the least, unsatisfactory; but the statement is generally made that, in accordance with a settled principle in equity, securities in the hands of sureties enure to the benefit of creditors, though in carrying out this principle the intention of the parties be entirely disregarded. In this view of the case it goes without saying that assent or knowledge on the part of the creditor is not necessary to perfect the trust; the transaction being for his benefit, his assent will be presumed.[1] It is as though the debtor had originally constituted the surety a trustee of funds with which to extinguish the debt when it became due, whereas the real object doubtless was to gain credit for the bond, note, or other obligation through the name of the surety, and at the same time leave him with the means of protection. True, the principal intended his debt should be paid, but it was to remain merely a personal claim against himself or his surety, and not to become a claim against any specific fund. The security is for indemnity against any loss the surety may incur on the credit given his principal. No holder is named as beneficiary in any contingency; the instrument is negotiated alone on the personal credit of the parties. Now, if a trust is created, it must be either express or constructive; if the former, it would appear from the language or intention of the parties; if the latter, it must be in order to accomplish justice. But there is nothing in the phrase "to indemnify the surety" from which to infer an express trust; and should the security, on the other hand, realize less than the debt, it is clear that if the creditor is allowed to appropriate it and then claim against the insolvent estate for the balance, the latter may be left without any means of reimbursement. This fact is in itself sufficient to negative the idea of a constructive trust, based on any principle of justice.

Frequently an analogy is drawn between the case we are now discussing and that of a creditor whose remedies against the principal debtor are transferred to a surety who has paid the debt.[2] In answer to this argument it is sufficient to say that in the latter case payment by the surety extinguishes the creditor's claim, and what he petitions for is a substitution to the creditor's remedies against

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[1] Baltimore & Ohio R.R. *v.* Trimble, 51 Md. 99, at 114; Moses *v.* Murgatroyd, *supra.*

[2] 1 St. Eq. Jur. § 638.

the principal debtor; in the former instance there can be no question of substitution proper, for the receipt of the surety's securities by a creditor does not relieve the surety from liability in case the securities prove insufficient. The relief by substitution is never extended but on the assumption that the debt has been or is to be paid in full, so that further detention of the security is against equity.[1] Another objection to allowing substitution is to be found in the fact that, the security being for the indemnity of the surety, he has no right to it till he has been damnified by payment; the creditor's remedies against the principal debtor, on the other hand, ripen as soon as there has been a refusal to pay. By subrogating the surety to the creditor's remedies against his debtor, the burden is finally placed where it belongs, and therein lies the equity of the transaction. No such object is attained in doing the converse of this, the only result of which is to place the creditor in an advantageous position to which he can lay no claim. The burden in the latter case is not always placed where it belongs: if the securities are sufficient in value, the burden will take care of itself; if they are insufficient, the loss, as has already been stated, will fall, in part at least, on the surety.

The case of Morrill *v.* Morrill[2] affords a good instance of the common American doctrine. There an infant's guardian executed a mortgage as security to a surety on his bond. It was held that the infant was entitled to its benefit for the amount due from the guardian. The language of the court is as follows: "When an assignment of securities is made by the principal to the surety for indemnity merely, an implied trust is raised in favor of the creditor, which he may enforce on the maturity of the debt, whether the surety has been damnified or not, and whether the surety or principal, either or both, are insolvent. The assignment of the security by the principal to his surety is an appropriation of funds for the ultimate discharge of the debt for which he is holden. The surety has a right to apply the security directly to the debt. If the surety pays with his own funds, he keeps his principal's debt on foot against him and then applies the security to its payment. Thus in any event the funds of the principal are made to satisfy the principal's debt, and this accords with the purpose of the principal when he gave the security. If the surety after assignment becomes

[1] Lawson *v.* Snyder, 1 Md. 79. See also in this connection Bispham's Equity, § 335.

[2] 53 Vt. 74, and cases cited.

insolvent or is discharged from liability, he holds the fund in trust for the creditor."[1]

In *Re* Jerome B. Fickett[2] the statement is made that there can only be complete indemnity by applying the security in payment of the debt; how this will be accomplished in the case of a deficiency in the security, the court do not undertake to say. If, for instance, the debt is $1,000, and the value of the security only $500, the surety will have to pay at least a part of the remaining $500 out of his own pocket. He will not only have to forego reimbursement from the security, but he will also be deprived of any remedy against his principal on account of the rule against double proof.

If we hold that in indemnifying the surety the principal creates a fund for the payment of the debt, two consequences follow: first, we preclude the former from ever relinquishing the security, even before insolvency and before the creditor has learned of its existence; second, we render any set-off in favor of the principal impossible. With regard to the first point there seems to be very little authority aside from a strong dictum in the case of Ijames *v.* Gaither.[3] As to the second point, there appears to be no authority at all. Though these two consequences are the logical and inevitable result of holding that a trust is created, it may nevertheless be doubted whether a court would not in an actual case shrink from these applications of their principle. If this be true, it is obvious that the word "trust" is used in a vague and inaccurate sense, and it follows, as we shall soon see, that there is no real distinction between the cases we have been discussing and those comprised under the next head.

In the second class of decisions the right of the creditor to the security is held to arise on the insolvency of the surety, but not before, and a result of this view is that until insolvency intervenes the surety may release the security if he sees fit. This doctrine

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[1] See to the same effect New Bedford Inst. for Savings *v.* Fairhaven Bank, 9 Allen, 175; Kelly *v.* Herrick, 131 Mass. 373; Vail *v.* Foster, 4 N.Y. 312; Barton *v.* Croydon, 63 N. H. 417; Harmony *v.* National Bank, 13 W. N. (Penn.) 117, n. 1; *Re* Jaycox, 8 B. R. 241; *Ex parte* Morris, 16 B. R. 572; *Re* Peirce, 2 Lowell, 343.

[2] 72 Me. 266.

[3] 93 N. C. at 363: "We think it clearly to be gathered from the authorities that as soon as such a deed of indemnity is given, the equitable right of the creditor attaches to it, and it is not within the power of the surety to put it beyond the reach of the creditor."

has obtained in a long series of cases in Connecticut, and as illustrating it we will refer briefly to a few of the more important ones.

In Thrall *v.* Spencer[1] the surety had parted with the security before his insolvency to the defendant, from whom the creditor sought to recover it, but the court held that the release was good. "The mortgage was not made to the holders of these notes, but to the accommodation indorser for his security." "He (the indorsee) has lain still until the latter (the indorser) had parted with possession. . . . He therefore comes too late for relief." And again: "The latter (the indorser) may well relinquish his pledge, provided he acts in good faith and without any fraudulent design before any claim is made on him for the property."

In Lewis *v.* Deforest[2] an accommodation indorser retained on his insolvency a portion of the funds given him for his indemnity, and the court held that the unpaid indorsees might have the latter applied in discharge of the debt. Both principal and surety were insolvent, but the decision is in no sense dependent on the former fact. In this case another point of interest was passed upon. The indorser had from time to time taken up notes to an amount greatly exceeding the value of the security, which gave him the right to appropriate the latter to reimbursement and to add the amount so received to his general assets; but since he had failed to do so before insolvency, his estate was only allowed to claim against the security in competition with the note-holders, whereby the general creditors were prejudiced. See also Moore *v.* Moberly:[3] "To the extent that payment has been made by a surety, he would be entitled to occupy the place and enjoy the rights of a particular creditor, receiving his *pro rata* share of the indemnity and leaving the residue of his payment as a loss to be borne by himself." Such a disposition of the mortgaged property can hardly have been contemplated by either party to the original transaction, nor is it fair under the circumstances that the note-holders should be paid at the expense of the other creditors of the surety.

In Homer *v.* N. H. Savings Bank[4] it appeared that the surety was indebted to his principal in an amount greatly exceeding the value of the securities given him for his indemnity. It was held

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[1] 16 Conn. 139. [2] 20 Conn. 427.

[3] 7 B. Mon. 299, 301. To the same effect are: Ray *v.* Proffet, 15 Lea, 517; Ijames *v.* Gaither, 93 N. C. 358; Kelly *v.* Herrick, 131 Mass. 373. See also Mr. Willard's article in 14 Am. L. R. at 857. [4] 7 Conn. 478.

that the creditor's rights could be no greater than those of the surety, and that consequently the former would take the securities, if at all, subject to the same set-off which was good against them while in the hands of the latter.

The doctrine of the Connecticut cases will be found to exist with slight modifications in several other States.[1] The rule in Ohio seems to be that where the surety's liability has been fixed by judgment and his principal has become insolvent, a court of equity will permit the creditor to proceed directly to appropriate the securities to the payment of the debt. "It prevents circuity of action, the surety is better indemnified, not being disturbed, unless his securities are insufficient, and the creditor has the benefit of having his claim satisfied." [2]

Why an equity should be held to arise in favor of the creditor on the insolvency of the surety is not quite clear. The latest Connecticut case [3] states particularly that the mortgage is both in effect and form for indemnity. That being so, is there any justice in saying that on the insolvency of the surety the right of his estate to indemnity suddenly ceases, merely because a particular creditor may otherwise have to forego full payment, or because he himself may no longer have control of his property? [4]

It is believed that the doctrines most prevalent in this country touching the right of a creditor to the securities held by his surety for his personal indemnity have been referred to,[5] and it is now proposed, thirdly, to consider the English decisions, the leading one of which is *Ex parte* Waring.[6] This case is at variance with the earlier one of Maure *v.* Harrison, and has undoubtedly settled the law of England on the question now before us. The rule of *Ex parte* Waring is that where both principal and surety are bankrupt, the creditors can claim the benefit of the securities. The facts of the case were briefly these: Brickwood & Co. had ac-

[1] St. Louis Ass'n *v.* Clark, 36 Mo. 601; Logan *v.* Mitchell, 67 Mo. 524; Stone *v.* Furber, 22 Mo. App. 496; Constant *v.* Matteson, 22 Ill. 546.

[2] Ohio Insurance Co. *v.* Reeder, 18 O. Rep. 35.

[3] Jones *v.* Quinnipiak Bank, 29 Conn. 15.

[4] In Alabama the creditor is substituted to the rights of the surety, to relieve the latter from the vexation of a suit and from having to resort to the security for redress. Toumlin *v.* Hamilton, 7 Ala. 362; O. Insurance Co. *v.* Ledyard, 8 Ala. 866; Saffold *v.* Wade's Ex., 51 Ala. 214; Daniel *v.* Hunt, 77 Ala. 567.

[5] The Mississippi cases will be mentioned in connection with the Scotch cases under head four.

[6] 19 Ves. 345; 2 Rose, 182, S. C. See also Eddis, Rule of *Ex parte* Waring.

cepted bills of Bracken & Co., and had received from the latter securities against their acceptances. First Brickwood & Co., then Bracken & Co. became bankrupt. The holders of acceptances had proved their debts under both commissions, and the assignees of the drawers' estate sought to recover from the acceptors such surplus as would remain from the proceeds of the securities after payment of the dividends due the several bill-holders. The latter petitioned to have the funds applied in discharge of the acceptances on the ground that they were held not merely for the personal indemnity of the acceptors, but for the ultimate payment of the bills. The court, while emphatically denying that the bill-holders had any personal claim to the securities, decide that where two bankrupt estates are being administered, since it would be inequitable for the one to keep the securities and equally inequitable for the other to get them back (as the latter only had a right to them on tendering their value or on relieving the acceptors' estate of all liability), the only way to adjust the equities between the two estates is to order the one in possession of the securities to apply them in discharge of the bill-holders' claims. "Accidentally another person gets an advantage for which he had not stipulated, by reason of the adjustment of equities between the parties."[1]

In order to bring a case within the rule of *Ex parte* Waring, the contract between the drawers and acceptors must be still in existence and incapable of alteration. Hence if only one of the parties be bankrupt, and the other's estate, though insolvent, has not been brought under any forced administration, the rule does not apply.[2] "Where there is no right of double proof, whatever may be the equities as between the two firms that are insolvent, I cannot see how there can be any difficulty in settling those equities between the parties without the necessity of giving to the bill-holder, who is simply a creditor without any security, the security which he has never bargained for."[3] The case of Powles *v.* Hargreaves[4] shows that the two estates need not be bankrupt in the technical sense, but that the rule is properly invoked where they are being wound up through the medium of a court of chancery. It is there also expressly decided that the rule applies, whether the secu-

[1] *Ex parte* Smart, 8 Ch. App., at 225, per James, L. J.

[2] *Ex parte* Lambton, 10 Ch. App. 405; *Ex parte* South Am. Co., 10 App. C. 635.

[3] Vaughan *v.* Halliday, L. R. 9 Ch. App. 561, 568, per Mellish, L. J.

[4] 3 De G., M. & G. 430.

rity be more than sufficient or insufficient to meet the acceptances. In the latter case the bill-holders may prove for the deficiency (p. 452).

The rule laid down in *Ex parte* Waring, though of easy application, is technical in its nature and unsatisfactory in its results, for in case of a deficiency in the security the acceptor's estate has no means of indemnifying itself for the amount paid on the subsequent proof. Thus, the very object for which the security was given is defeated. Then, again, the court admit that the bill-holders have no claim to the security through any right inherent in themselves, and yet it is ultimately handed over to them. If the creditors have no right to it, it would seem wrong that it should enure to their benefit to the prejudice of another. It is a confession of weakness on the part of the court to be driven to such a result, and that the problem admits of another solution is, we think, amply demonstrated by the case of The Royal Bank of Scotland *v.* The Commercial Bank of Scotland,[1] which brings us to the fourth and last subdivision of our topic.

According to the Scotch rule the surety has no right to the security except to indemnify himself for payments actually made, nor have the bill-holders any direct claim, though both principal and surety are insolvent; but if the surety's estate pays a dividend for which it is reimbursed out of the security, a new general asset is created; thus, incidentally, in the winding up of the surety's estate, all the creditors derive a certain benefit from the indemnity fund.[2] Whatever may remain of the latter goes back to the principal's estate.

The facts of the Scotch case just mentioned were as follows: By agreement between A and B the latter undertook to employ his works in spinning yarns. All material at B's works was to continue A's property subject only to B's lien for advances made by him. A and B became bankrupt. B was liable as acceptor

[1] 7 App. 366.

[2] The same rule obtains in Mississippi. Poole *v.* Doster, 59 Miss. 258. In studying the earlier cases (Bibb *v.* Martin, 22 Miss. 87; Bush *v.* Stamps, 26 Miss. 463; McLean *v.* Ragsdale, 31 Miss. 701; Carpenter *v.* Bowen, 42 Miss. 28; Osborn *v.* Noble, 46 Miss. 449) it must be constantly borne in mind that they are of three kinds, viz.: *First*, Where the security is given to secure payment of the debt. *Second*, Where the surety has a power to sell the security and apply the proceeds in discharge of his obligation as soon as his liability has become fixed. *Third*, Where the security is given merely for the surety's indemnity. The remarks about subrogation only apply to the first two classes.

on bills drawn by A to the amount of £16,000, and he held goods belonging to A of the value of £4,000 as a security against his acceptances. The bill-holders claimed that the proceeds of the goods should be applied in payment of the bills, so as to reduce the amount of their proof against the two estates to £12,000. B's trustees, on the other hand, contended that the bill-holders would have to prove against both estates for the full amount, and that all dividends paid from B's estate should be repaid from the security. The court in an elaborate opinion refused to follow the rule laid down in *Ex parte* Waring, the benefit of which was claimed by the bill-holders, on the ground that in many cases it failed to indemnify the acceptor's estate, and that it distributed the drawer's property in a manner which he had never contemplated.

It will be of interest to compare the different ways in which the general creditors of both estates will be affected according as the English or the Scotch rule is applied. Let us suppose the liabilities of drawer and acceptor to be £100,000, and their assets to be £50,000; let us assume further that the bills outstanding amount to £5,000, and that the securities in the hands of the acceptor are worth £2,000; then by the rule of *Ex parte* Waring the bill-holders would receive £2,000 and be allowed to prove against the two estates for £3,000, obtaining from each £1,500. Thus they would collect in all £5,000, or exactly what was due them. The assets remaining in the hands of the acceptor and drawer would in either case be £48,500. By the Scotch rule the bill-holders would also recover £5,000 by proving against the two estates, but in this instance, after payment of the bills and reimbursement from the securities, the acceptor's assets would be £49,500 and the drawer's only £47,500. In other words, the acceptor's estate would in the first case be subjected to a loss of £1,500 and in the second to a loss only of £500. As the securities were given to save the acceptor harmless, it is evident that the latter result is the one most in keeping with the intention of the parties. It is only just that the drawer's estate should be made to pay its own debts, and not place the burden of them on the acceptor's estate.[1]

It is always for the advantage of the general creditors of the ac-

[1] The figures used with reference to the English rule apply equally to the general American rule in cases where both principal and surety are insolvent. The above dividends, taken individually, may be only approximately correct. Their exact amount will depend on whether proof is made against the two estates concurrently or separately.

ceptor's estate that the Scotch rule be followed, for though the amount of proof be thereby increased, yet by resorting to the securities the estate can reimburse itself frequently to the full extent of payments made. No such rule can be laid down with regard to the creditors of the drawer's estate. In the above illustration it so happened that the English rule was the one most favorable to them; but where the acceptor's estate pays a very small dividend and the drawer's estate, on the other hand, pays a large one, the creditors of the latter will usually be benefited by the carrying out of the results reached by the Scotch courts, for in such cases only a small share of the securities is required for the surety's indemnity, and the portion that is returned to the principal's estate will frequently more than offset the loss occasioned by reason of the increased proof.

With regard to the bill-holders, we may say that by the application of the English rule they will always be benefited at the expense of the general creditors of the acceptor's estate,[1] and sometimes, as will follow from what has already been said, at the expense also of the general creditors of the drawer's estate.

An apparent difficulty in applying the Scotch rule arises from the fact that as soon as the acceptor's estate has been indemnified for the first dividend paid to the bill-holders, the amount thus withdrawn from the security becomes an asset from which all creditors, the bill-holders included, are entitled to another dividend; if any part of the security still remains, the same process is repeated, *i. e.*, the bankrupt estate may reimburse itself to the amount of the bill-holders' share of the second and other dividends, until the whole of the security has been appropriated to its indemnity. Now it frequently happens that the dividends decrease much more rapidly than the security, in which event the above process would have to be carried on *ad infinitum*. As soon as it is discovered that this would be necessary, a simple formula[2] will

[1] We may except the case where the securities together with the dividends obtained from the drawer's estate are sufficient to pay the bill-holders in full.

[2] Suppose the acceptor's estate be able to pay 40% dividends, its liabilities being £10,000 and its assets £4,000; assume that the bills aggregate £6,000 and that the securities will yield £5,000. The first dividend of the bill-holders will be £2,400, the second 24% of £6,000 or £1,440, the third £864, the fourth £518 8 s. By this time the securities will be found to have been exhausted, and the acceptor's estate will suffer to the extent of £400. Now let us assume that the assets are £2,000 instead of £4,000, the liabilities, bills, and securities remaining the same as before. The first dividend will

it is submitted, determine the exact amount of all the dividends due each individual creditor. No such computation was rendered necessary in the case of The Royal Bank *v.* The Commercial Bank, 7 App. 366, because after the third dividend the security was exhausted.

It will be seen that in many cases the bill-holders are materially benefited by the fact that the acceptor holds funds for his indemnity, and it may be objected that to allow them to share in any way in the distribution of the latter is inconsistent with the very foundation on which the Scotch rule rests. In reality, however, what they receive is not taken from the securities as such, but from the assets of the debtor. The bill-holders do not occupy the position of preferred creditors, for they share the sums derived from the securities *pari passu* with the general creditors; nor do they profit at the expense of the acceptor's estate, since the latter has a right to reimbursement for every dividend paid. It is inevitable that the amount withdrawn from the securities should in its turn become an asset, and it is only just that the bill-holders, whose debt has not yet been extinguished, should be allowed to prove against it in competition with the other creditors.

Of the four views presented the last would seem to be the only one consistent with justice and the intention of the parties.

William Williams.

HARVARD LAW SCHOOL.

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be £1,200, the second £720, the third £432, etc. In this case it soon becomes evident that the securities will never be exhausted, though the above process be carried on *ad infinitum*. Now the aggregate of all the dividends may be readily determined as follows: The numbers 1,200, 720, 432, etc., will be found to constitute a geometrical progression, the ratio (e) of the terms of which is $\frac{720}{1200}=\frac{3}{5}$, and their number infinity. Taking the formula $s=\frac{a}{1-e}$ (a being the first term of the progression) we find the sum of the dividends in this case to be £3,000. The total amount of the securities to be divided among all the other creditors will be found to equal £1,200, or the first dividend. For if the bill-holders' dividends are a, b, c, d, *etc.*, to infinity, those of the general creditors will be $a—b$, $b—c$, $c—d$, *etc.*; the last dividend being infinitely small, it will be found on addition that all the terms except a vanish. Having thus ascertained the total amount due the general creditors, it will only remain to distribute it in proportion to their respective claims.